No. 90-516

In The

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY BRIEF FOR PETITIONER

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POINT I

DIRECTORIAL ANTAGONISM EXCUSES DEMAND

In her main brief Petitioner pointed out (pp. 14-18) that the decisions of this Court establish that when a corporate directorate opposes a shareholder suit the futility of a demand by the shareholder is established. In *Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 451 (1909), this Court pointed out that "the good faith of the directors need not be questioned. . . . The attitude of the directors need not be sinister. It may be sincere." It is sufficient to excuse demand and comply with Rule 23.1 of the Federal Rules of Civil Procedure if it be alleged that the directors are "firm to resist appeals".

In *Smith v. Sperling*, 354 U.S. 91, 97 (1957), a majority of this Court held that "Whenever the management refuses to take action to undo a business transaction or whenever, as in this case, it so solidly approves it that any demand to rescind would be futile, antagonism is evident." The minority in *Smith v. Sperling* agreed that sincere opposition by the directors is sufficient to render demand futile. 354 U.S. 99, 110 (1957).

The opposing briefs, including those of the opposing *amici*, almost completely ignore these holdings. *Smith v. Sperling* is referred to but once, in a footnote to the brief of respondent Adviser ("KFS"), where the case is sought to be distinguished as dealing merely with diversity jurisdiction (p. 16 n. 12). By sweeping these authorities under the rug, KFS pretends that "this Court has never endorsed a futility exception," at least within the past sixty years. *Id.*, p. 30.

Respondents' desire to wish away this Court's holdings that directorial antagonism excuses demand is occasioned by the fact that directorial antagonism is abundantly present in this case. Contrary to the assertions of both respondents (KFS p. 15; Fund p. 9), the Fund in its initial answer opposed the proxy fraud claim on its merits. J.A. 27. KFS acknowledges (p. 15) that the directors asserted the belief that the proxy claim lacked merit. Additionally, the Fund concedes (p. 13) that the directors participated in the distribution of the proxy statement.

Respondents portray the allegations in ¶ 17(b) (92a) as reciting merely that the directors received compensation for serving as directors. However, that is not the case. The seven so-called "non-interested" directors serve as directors of all of the mutual funds in the Kemper Group, for which they receive aggregate remuneration of approximately $300,000 per year. This is far higher pay than would be received simply as serving as a director. Indeed, a director would have to attend all six board meetings during the year to receive approximately $5,820 if he were a director only of the Fund.[1] This would be appropriate directorial compensation. However, by serving as directors of all of the other mutual funds in the Kemper Group and receiving an aggregate of $300,000 per year, the directors, as it is alleged, are dependent upon and subservient to KFS. This is not, thus, simply a matter of being compensated for serving as a director, but of being beholden to management in the same manner as employees.

[1] 1984 Proxy Statement p. 4. KFS agrees in its brief (p. 2 n. 3) that the Proxy Statement may be judicially noticed.

As pointed out above, futility of demand is established by directorial antagonism, no matter how sincere. But even if respondents are correct that demand will be excused only upon a showing that the directors have a bias or antagonism so severe as to render them incapable of discharging their duties, that criterion is met in this case. The directors committed the very wrong complained of by distributing the false proxy statement. They have opposed the suit on its merits from the very beginning. By virtue of their extraordinarily large remuneration, they are financially dependent upon the Adviser. If, under these circumstances, state law, if otherwise deemed applicable, would nevertheless require a demand, then that requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act and ought not to be enforced. We deal with that point below (Point IV).

POINT II

MARYLAND LAW EXCUSES DEMAND

Both respondents agree that Maryland law contains a futility exception. However, KFS seeks to distinguish the instant case from Maryland authority principally on the ground that the complaint herein does not use the word "fraud".

The contention borders on the frivolous. ¶ 13 of the Complaint alleges that the proxy statement "misleadingly described the fees" paid by a sister fund and "gave the false impression that the fees paid" by the sister fund were as high or higher than the fees paid by the Fund. 90a-91a. The directors were also directors of the sister

fund (92a) and thus knew that the fee structure was falsely represented. Accordingly, the Complaint asserts that any suit "brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund". ¶ 17(c), 93a. This is, of course, the very language of fraud, and is highly similar to the language contained in the complaint in *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940 (1971), as described in the opinion in that case.

In addition to the authorities cited in petitioner's main brief, *amicus* Investment Company Institute has cited the case of *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990), in which the Court held that the Maryland futility exception excuses demand even more readily than federal law.

POINT III

ABOLITION OF THE FUTILITY EXCEPTION IS UNCALLED FOR

Respondents also contend that the futility exception should be abolished. Here however, their paths diverge from those of their *amici*. The Business Roundtable opposes abolition of the futility exception at the federal level, stating that a universal demand rule would create a "procedural nightmare". Br. p. 5. The Investment Company Institute argues that elimination of the futility exception is warranted in cases arising under the Investment Company Act because of the regulatory controls to

which investment companies are subject. As we show below, the reasoning of the respondents and the Investment Company Institute is unsound and unsupportable by history, law or logic.

The principal argument which KFS makes in support of its plea to adopt a universal demand requirement is the development of special litigation committees. According to KFS (Br. p. 30), the use of special litigation committees is not a defensive reaction to shareholder inquests, but a device which "better insure[s] compliance" with corporate fiduciary standards. KFS maintains that special litigation committees are synonymous with public accountability; whereas, continuing its inversion of logic, it equates the excusing of demand where futile to a free-wheeling, laissez-faire approach to business and business entrepreneurs. *Id.*, pp. 29-30.

Adoption of a universal demand requirement, claims the respondent, will relieve the courts of "gobs of litigation" (*id.*, p. 22) and will promote intracorporate alternative dispute resolution, with the only cost to shareholders being "the inability to file or maintain suit." *Id.*, p. 27. It is, says KFS, the cynical views of shareholders such as petitioner which cause them to rush to the courthouse to file suits without first making a demand that might allow the matter to be resolved without litigation. *Id.*, p. 32.

But it is neither cynical nor speculative to predict that a universal demand requirement will spell the demise of shareholder derivative litigation. As the Court stated in *Joy v. North*, 692 F. 2d 880, 888 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) (footnote omitted):

> As a practical matter, new board members are selected by incumbents. The reality is, therefore, that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee.

Professor Dent, discussing the use of special litigation committees, states, "In no case known to the author have the directors agreed to sue." Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw. U. L. Rev. 96, 109 n. 70 (1980).

KFS contends that Petitioner's assessment is wide of the mark because the standard for judging the board decision not to sue will be that supplied by state corporate law, whatever that law may be. Br. p. 27 and n. 19. The Business Roundtable apparently acknowledges the validity of petitioner's concern if the board refusal were to be evaluated pursuant to the business judgment rule. Br. p. 21 n. 8. It quickly adds that the business judgment rule is the standard utilized under current law in cases in which demand is required. *Id.* In the so-called "demand excused" cases The Business Roundtable asserts that judicial review, at least in Delaware, is more favorable to plaintiffs. Br. pp. 18-19. But even there, as the *amicus* concedes, review is limited to the independence and good-faith of the special litigation committee coupled with a business judgment evaluation. *Id.* p. 19. Meritoriousness, if considered at all, takes a back seat. As

petitioner pointed out in her main brief (pp. 19-21 and n. 9), the utilization of special litigation committees thus imposes insuperable obstacles upon the plaintiff and burdens upon the judicial system.[2]

In a paradigm of circular logic KFS argues that it is not naive to assume that directors will promptly and forthrightly respond to a demand. If the directors do attempt to thwart action against them by appointing a special litigation committee, "shareholders will take action against" them. Br. p. 28 n. 20. Presumably with pitchforks.

In short, a universal demand requirement leads to a special litigation committee, which, ineluctably, leads to dismissal of the action, no matter how meritorious.

Amicus Investment Company Institute argues (Br. pp. 7-13) that, whatever the law with respect to other corporations, a universal demand requirement should apply to investment companies because of the statutory requirement that disinterested directors serve on the board. But as the SEC points out (Br. p. 19), it would be incongruous if the disinterested-director requirement, which attempts to compensate for special conflicts of interest in investment companies, actually diminished the rights that

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[2] The "gobs" of litigation to which the court of appeals and the respondent refer are highly imaginary. In fiscal 1990, out of 217,879 cases commenced in U.S. District Courts only about 1%, 2,442, were cases dealing with securities, commodities or exchanges; and only a small fraction of those – so small that the category is not broken out – were derivative actions. 1990 Annual Report of the Director, Administrative Office of the United States Courts III-14 – III-15.

shareholders in all other public companies enjoy. Moreover, although federal law mandates that disinterested directors serve on the board, it cannot and does not purport to guarantee that the disinterested directors will, as a factual matter in every instance, be able to act independently with respect to a particular transaction. For example, the Act does not address the possibility that a director who approved a transaction may be incapable of impartially evaluating whether the transaction violates federal law. Because the Act does not certify that a "disinterested" director is necessarily impartial in all instances, the futility exception does not conflict with the policy of the Investment Company Act.

The ICI's own arguments militate in favor of preserving the futility exception. The ICI correctly points out that Congress, in amending the Investment Company Act in 1970 to add § 36(b), stated that it wanted it to be understood that the section was not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. ICI Br. p. 11 n. 36, quoting from Senate Report No. 184. As petitioner pointed out in her main brief (pp. 27-28), one of the concepts which Congress wished to retain was the continued ability of shareholders to maintain private derivative actions. Thus, in *Tannenbaum v. Zeller*, 552 F.2d 402, 434 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977), the Court of Appeals held that "despite the repeated and extensive disclosures to the independent directors about recapture," a shareholder had the right to maintain an action for damages caused to the fund by proxy statements which failed to present that

subject to the shareholders.[3] *See also Papilsky v. Berndt*, 503 F.2d 554 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974) (denial of motion to dismiss shareholder's action under Investment Company Act for lack of demand on directors held not appealable). If the futility exception were truly at odds with the structure and requirements of the Investment Company Act, as the ICI contends, Congress would have said so and would not have repeatedly amended the Act while endorsing the implied private rights of action the courts had previously sustained.

Finally, the ICI contends that petitioner did not claim any injury due to the proxy fraud other than the excessive fees and in any event has no right of action under § 20(a) of the Act. It is well settled, however, that proxy claims and other rights of action under the securities law are cumulative, rather than exclusive of one another. See *SEC v. National Securities, Inc.*, 393 U.S. 453, 468-69 (1969) (proxy claim under § 14 of the Exchange Act may overlap with a claim under § 10(b) and Rule 10b-5). Moreover, the complaint does allege damage to the Fund and its shareholders as a result of the proxy fraud. Complaint ¶ 13, 91a. The damage occasioned by the proxy fraud is not

[3] At p. 6 n. 13 of its brief the ICI argues that section 36(b)(3) of the Investment Company Act precludes an action for damages against fund directors. In fact that section of the Act precludes an action for excessive advisory compensation against anyone other than the recipient thereof. It does not preclude an action against the directors for damages resulting from proxy fraud. Nevertheless, the insulation of the directors from liability for approving excessive compensation to the investment adviser reduces rather than increases the protection which shareholders might expect to receive from those directors.

measured by the same yardstick which is used in excessive advisory compensation cases under § 36(b). The latter class of cases depends largely upon profitability; *See, e.g., Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404 (2d Cir.), *cert. denied*, 110 S. Ct. 281 (1989). Proxy fraud, however, is subject to a somewhat different standard of measurement which starts with a determination of the impact upon the shareholders' vote; *see TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). In the present case, for example, the difference in fees falsely represented amounted to approximately $10 million per year (see petitioner's main brief p. 9).

The maintainability of shareholder proxy fraud cases was established at least as early as 1964 in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), and applied to § 20 of the Investment Company Act in, *inter alia, Tannenbaum v. Zeller, supra*. A lengthy exposition is contained in the District Court's Opinion at 39a-46a, and will not be reiterated here. Suffice it to say that the contention that there is no private right of action under § 20 was not raised by any of the respondents either in the Court of Appeals or in this Court.

So far as we are aware the universal demand requirement has never been embraced by any court other than the court below. Its adoption would reverse over a century of careful and conservative adumbrations and refinements by this Court. The result would be a vast loss in investor protection which, in the long run, would prove detrimental to the ability of the capital markets to raise financing for American industry. No such radical departure should be endorsed by this Court.

POINT IV

IN THE FACTS OF THIS CASE IMPOSITION OF A DEMAND REQUIREMENT WOULD BE INCONSISTENT WITH THE FEDERAL POLICY UNDERLYING § 20 OF THE INVESTMENT COMPANY ACT

In *Burks v. Lasker*, 441 U.S. 471, 479-80 (1979), this Court held that the application of state law to directorial action concerning claims under the Investment Company Act would be countenanced unless the application of state law would be inconsistent with the federal policy underlying the cause of action.[4] Noting that hostile state rules would not be permitted to destroy federal rights, this Court cited, *inter alia, Levitt v. Johnson*, 334 F. 2d 815, 819-20 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). In *Levitt* the Court of Appeals for the First Circuit refused to apply a Massachusetts rule which would have required demand upon shareholders in a derivative action seeking to enforce rights under the Investment Company Act. In reversing the dismissal of the action for failure to make such a demand, the Court of Appeals based its rationale upon the fact that the demand would be pointless because of the enormous obstacles which the plaintiff would face in attempting to convince a majority of the shareholders to endorse his action. Given the factual circumstances of the present case the inevitability of the outcome of a shareholder demand upon directors is equally manifest. A shareholder demand upon directors here faces no prospect of success, regardless of the merits of the underlying cause of action. Accordingly, insistence upon the demand would conflict with the Investment

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[4] *Burks* was an atypical derivative action in that no self-dealing was involved.

Company Act and must yield to that senior policy interest.

CONCLUSION

It is true that the typical large American corporation engages in thousands of transactions which are ordinarily the obligation of the corporate officers and its directorate to enforce or repudiate. Shareholder suits, however, are not concerned with those transactions. As The Business Roundtable concedes, virtually all derivative cases such as the present one involve allegations of self-dealing (Br. at 20 – 21). If there is to be any modification at all in this Court's solidly established rule that directorial opposition is alone sufficient to dispense with demand, let it be limited to those cases in which no conflict of interest is shown. Such a case was *Brooks v. American Export Industries, Inc.*, 68 F.R.D. 506 (S.D.N.Y. 1975), in which no potentially culpable defendant was a member of the corporate board of directors and the shareholder sought to preempt an action which the corporation was actually considering pursuing. Short of such an exceptional situation, however, the long-established jurisprudence of this Court, happily endorsed by the Congress, has well served the beneficial purposes of enforcing the federal securities laws and contributing to the policing of fiduciary responsibilities.

The Court of Appeals decision on the question presented for review is an aberration. It should be reversed and the case remanded for further proceedings.

Respectfully submitted,

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